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C O N F I D E N T I A L KATHMANDU 000891

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DEPT FOR SCA/INS AND EB/IFD

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TAGS: ECON FAID EFIN PGOV PTER NP

SUBJECT: IFIS ARGUE FOR CONTINUED ENGAGEMENT IN NEPAL

REF: A. 05 KATHMANDU 2820

1B. KATHMANDU 638

Classified By: Ambassador James F. Moriarty, Reasons, 1.4 (b/d).

Summary

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11. (C) During an April meeting with the Ambassador, International Monetary Fund (IMF) Resident Representative Sukhwinder Singh, World Bank (WB) Country Director Ken Ohashi, and Asian Development Bank (ADB) Country Director Hafeez Rahman stressed that ongoing development work was important and making a difference to Nepal's poor. They noted that His Majesty's Government of Nepal (HMGN) continued to make progress on reform. They made a strong case for being able to use budgetary support to press the government to continue its reforms, explaining that program assistance gave the multilateral donors overall leverage to use on HMGN. The international financial institutions (IFIs) clearly are trying to maintain a coordinated multilateral strategy in Nepal. End Summary.

HMGN Taking Right Steps on Reform

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12. (C) WB Director Ohashi explained that HMGN had met three of the World Bank's biggest conditions for the Poverty Reduction Support Credit (PRSC) II loan (between USD 70-100 million) (ref A). The government had enacted Labor law (ref A), taken steps to have a market-based fuel pricing mechanism (ref B), and passed a Governance Act. The government still had to address the issue of willful defaulters, and a number of smaller issues. Singh remarked that Minister of State for Finance Roop Jyoti appeared increasingly nervous about the defaulter issue. Ohashi noted that if Nepal satisfied the conditions for PRSC II, it would also clearly be eligible for debt relief under the Highly Indebted Poor Countries (HIPC) program, which could amount to USD 40-50 million/year. Ohashi pointed out that budgetary support was more effective than project loans in providing the IFIs with levers to influence the full range of Nepal's economic issues.

## Timing of Loans

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¶ 13. (C) Ohashi noted that the government "was desperate to get the PRSC loan before the end of Nepal's fiscal year," which ends July 15. However, he explained that it was almost technically impossible to meet that target because budget support was linked to Nepal's budget, which the WB would need to review. He said he expected that the loan was likely to go through in early October. ADB's Rahman commented that the ADB had USD 21 million in two program loans, one focused on governance reform, and the other on privatizing public enterprises. He added that HMGN had met many of the conditions, which had entailed costs, to meet the conditions for the second tranche of the governance loan. (The only major outstanding condition was entering information about 17,000 primary school teachers into a personnel computer system.)

¶ 14. (C) IMF Resident Representative Singh explained that the IMF Poverty Reduction and Growth Facility, a three year program, was due to expire in November 2006. He remarked that HMGN had made substantial progress, pointing to progress on fuel pricing, and saying that the two or three outstanding issues were "doable." The IMF would send a team to Kathmandu in June, as it did every year, to help HMGN on its budget. Singh stressed that the IMF would like to see all the multilaterals move forward together and take a coordinated approach.

## Still Enough Development Space

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¶ 15. (C) All agreed that there was still enough development space for a wide range of activities. Ohashi noted that the Middle Marshyangdi hydropower project was moving along briskly. Rahman commented that ADB's level of disbursement in Nepal doubled last year. ADB focused on roads, water supply and education projects. Ohashi remarked that the WB's level of disbursing 22 percent of monies connected to all approved loans this year was "not bad;" the WB's institutional average was 25 percent.

## Macroeconomic Framework Still On Track ...

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¶ 16. (C) While acknowledging that Nepal's macroeconomic stability could be at risk, Singh stated that currently the macroeconomic framework was still on track. Inflation, currently at 8 1/2 percent, was within IMF estimates and reflected in part Nepal finally getting its fuel prices in line with international market prices. Despite capital flight, low levels of investment, and a decrease in exports to India because of additional customs duties, remittances continued to sustain the economy. He explained that the informal economy, including trade with India and remittances, was uncaptured in official statistics. Hafeez added that, although Nepal's economy risked getting stuck in low-growth mode, he did not believe it would collapse. However, very little private investment in the economy and huge constraints on public investment eroded Nepal's potential to grow in the future.

## ... But Budget Coming Under Greater Pressure

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¶ 17. (C) Singh commented that, because of the deteriorating economic situation, Nepal's budget was coming under greater pressure. Like most budgets, Nepal's budget was ambitious and had revenue growth projected at 16-17 percent, whereas revenue growth would likely be between four and eight percent, leading to an overall budget revenue shortfall of 6-7 billion rupees. Singh commented that while Minister of State for Finance Jyoti had tried with two sets of ordinances to tighten Nepal's VAT regime, his action in decreasing tariffs could well lead to a decrease in revenues. In addition, some budget support in the form of foreign financing had not materialized, and revenues in non-tax

royalties, such as telecommunications and electricity, were also down. On the expenditures side, Singh explained that there was not much "scope" to save on debt servicing or salaries, although capital expenditure was expected to be 4-5 billion rupees less than projected.

Economy A Pressure Point on King

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18. (C) The IMF resident representative pointed out that the economy was clearly one area that contributed to the increased overall pressure on the King. Singh noted that, if the King could not deliver either on peace or a solid economic performance, then people would question more and more the benefits of the monarch taking over. The combination of Nepal's political and economic issues could lead to serious macroeconomic problems. Singh argued that the IMF wanted to stay engaged to prevent these problems.

Comment

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19. (C) While the multilaterals remain committed to providing budgetary support and taking a coordinated approach to Nepal, many bilateral donors are not on the same page. Of particular note, the British development agency, DFID, a major bilateral donor, is becoming more aggressive in linking development assistance with political change.

MORIARTY